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ISSUE 5 | VOLUME 5 | NOVEMBER 2016

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

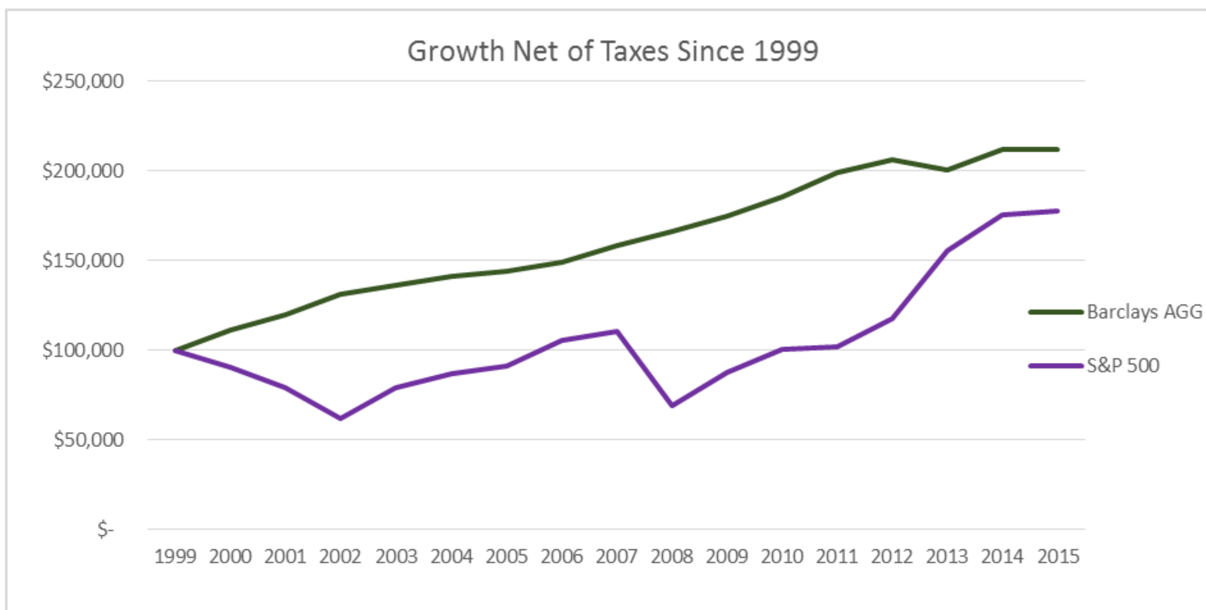
It's Not What You Pay, It's What You Keep

When it comes to taxes and investing, it is wise to keep an eye on the taxes your different investments are generating. However it is unwise to fixate on taxes to the extent other important investment concepts are ignored. "Out of the frying pan, into the fire" is an expression most people understand equates to trading a bad situation for a worse one. Paying taxes might be the frying pan, and all things being equal we'd rather not pay taxes than pay taxes, however they're not worth trading for the fire that is poor performance. Despite investors' good intentions to reduce the taxes generated by their investments, selecting investments and constructing portfolios with the intention of reducing income taxes can easily lead to worse after-tax performance than underweighting concepts like risk, diversification, and tactical management.

QUALIFIED DIVIDENDS

For tax purposes, investments generate ordinary dividends and qualified dividends. The IRS and state tax authorities tax ordinary dividends at regular income tax rates, but they tax qualified dividends at lower capital gains tax rates. In general, dividends generated by domestic common stocks are qualified, whereas interest generated by bonds is not. This distinction can steer people to invest in common stocks, equity mutual funds and equity ETFs instead of bonds, bond mutual funds or bond ETFs because they want to grow their investments in part through tax savings. It seems to make sense considering both a retired couple with taxable income of ~$40,000, and a family of four with taxable income of ~$210,000 would save around $300 in taxes the first year by investing $100,000 in an S&P 500 index as opposed to a Barclay's Aggregate Bond index. As those investments grow over time, the tax savings would grow too.

However choosing your investments based on tax savings and not based on the risk of principle loss is clearly a case of the tax tail wagging the investment dog. Since 1999, had the family of four invested in an S&P 500 fund and the retired couple invested in a Barclays Aggregate Bond fund, and had both families paid the taxes from the investments, the growth over time of the two investments would have been:



Of course investing in any stock investment as opposed to most bond investments during the tech bubble would have ultimately worked out poorly, but that is the nature of risk. When asset prices are high, especially historically high like they are right now, the chances of a riskier investment paying off in the short to medium-term are lower than when asset prices aren't at these all-time highs, and prices can remain down for very long periods of time. Had you invested in the S&P 500 in September of 1906, you wouldn't have been made whole again on an inflation-adjusted basis until September of 1928; a 22 year span. At that point in time your investment would have grown for one year and then plunged again, this time not recovering for 29 years on an inflation-adjusted basis. Periods like this occurred between the late 60's and early 90's, and the afore-mentioned 2000-2014 as well. You would have been collecting income on that investment and paying less in taxes than had you invested in something safer, but the tax savings and income would have taken years to overcome such long-term losses of principal.

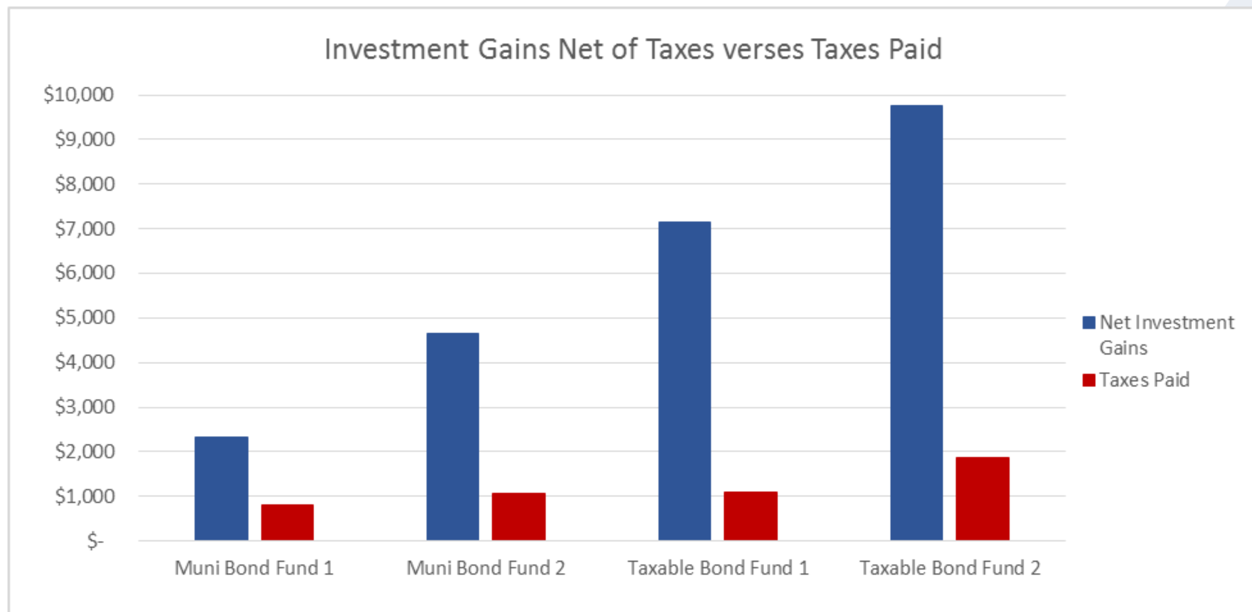
So worry about proper diversification and invest based on the appropriate timeframe. Investing JUST with taxes in mind can lead to extremely undesirable outcomes.

MUNICIPAL BONDS

That last example compared a relatively risky asset to a relatively conservative one, but there are even distinctions within conservative areas themselves. Take the case of municipal bonds, or "Munis" as they are frequently called. To encourage investors to buy bonds issued for large-scale, community-benefitting projects like building highways and water treatment facilities, the federal government does not charge income taxes on the interest an investor receives from most municipal bonds, including municipal bond mutual funds. As a bonus, investors also forgo paying state income taxes on the interest generated on muni bonds issued by their state of residence.

Because of this favored tax status, it is very easy to focus on the taxes that are being saved and forget that at the end of the day, maximizing the gain net of taxes is more important than the taxes themselves. Take for example four different bond mutual funds, two of which are Muni bond funds and two of which are regular bond funds which can own anything they want. We do not want this piece to be about the specific funds, so we have not identified them by name, but these are existing funds.

Had you invested $10,000 in each fund 11 ½ years ago and, if you owned these funds in a taxable investment account, and if your highest income tax bracket was 25%, the after-tax gains and taxes paid on all four funds through the years would have totaled:



As you can see, you would have paid a lot less in taxes in Muni Bond Fund 1 than Taxable Bond Fund 2, but you would have 316% more in after-tax profits had you chosen the taxable fund instead. There are a couple questions you may have about this comparison, namely:

Why are you paying federal taxes at all on the Muni funds if they are supposed to be tax free? Because it would have still generated capital gains, which are different from interest income and therefore taxable even for Muni bond funds. In this example, the capital gains on all four funds would have been taxed at 15%.

What about the different risks involved with investing in those two funds? Isn't it true that Muni Bond Fund 1 might be a lot less risky than Taxable Bond Fund 2, and therefore even though Taxable Bond Fund 2 has performed better over this timeframe, all we need is another market crash to make the potentially safer Muni Bond Fund 1 worth it in the end? In this case, believe it or not, the fund we used to supply the data for our Taxable Bond Fund 2 carries about the same amount of risk as the one we used to supply the data for Muni Bond Fund 1, and even outperformed that Muni bond fund during the financial crisis of 2008.

Because of Muni bonds' favored tax status, the higher the investors' tax brackets, the more tax benefits are derived from owning municipal bonds. Using the same funds, the results for an investor in the very highest income tax brackets all those years would have been the same: the after-tax gains for the taxable bond funds were larger than the after-tax gains for the Muni bond funds. If that's the case, why should people invest in Muni bonds at all?

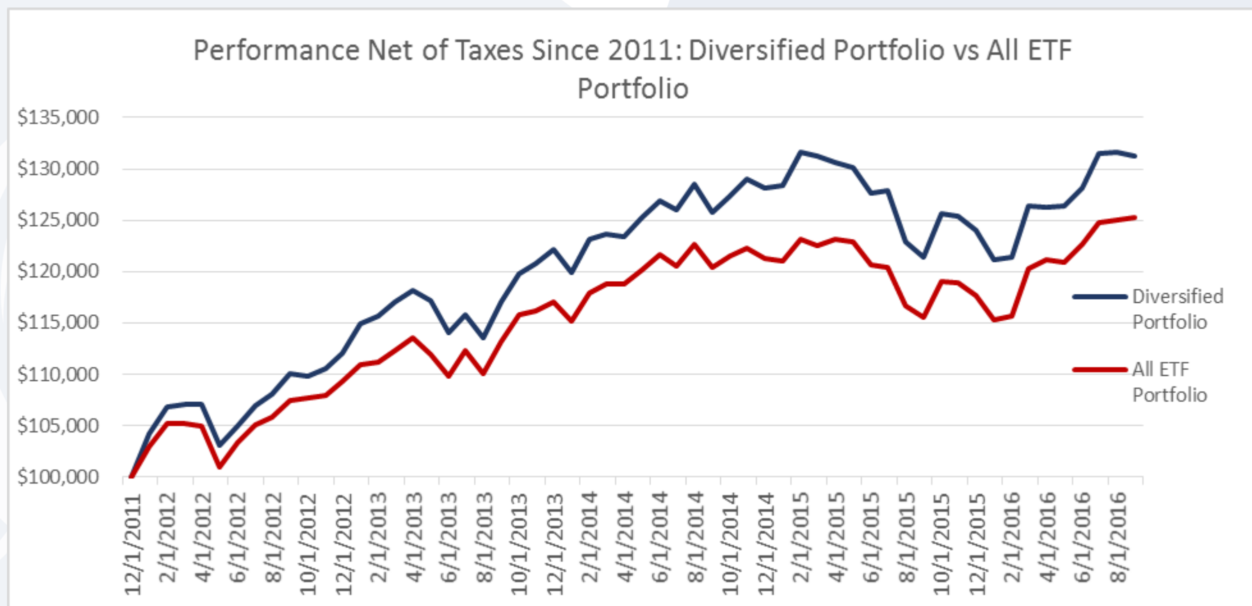
Because they can still outperform many taxable bond investments on an after-tax basis over certain time periods. People also own them for diversification purposes, which is why we do currently own Muni funds in many of our taxable client portfolios. There are times when municipal bonds perform very well compared to other bond sectors and can help bring up the overall returns on the fixed income portion of our clients' portfolios. And, of course, after risk-reward and diversification is taken into account, tax-free income is still nice to receive when you can get it.

TAX-EFFICIENT INVESTMENT PORTFOLIOS

Dividend-paying common stocks and municipal bond funds are tax-efficient based on their very nature and how they are favored by our tax code. How investments are managed is another way to increase or reduce the tax-efficiency of a portfolio. In general, the more frequently investments are bought and sold, the more likely any gains generated will be taxed at short-term capital gain rates which are the same as regular income tax rates, as opposed to long-term capital gain rates which are lower than regular income tax rates. Therefore, investments and investment portfolios that have less buying and selling will, in general, be more tax-efficient than those with more buying and selling, however proper tactical management of investments in key areas like bonds and alternative investments may yield better after-tax results BECAUSE of more buying and selling.

Unlike the first two examples, most investors own a variety of investments inside their portfolios, and the tax-efficiency of those portfolios are affected both by what is owned and how often those investments are bought and sold. Exchange Traded Funds, or ETFs, which we have mentioned previously in this and other newsletters, are investments that are considered tax-efficient because of how little they generate in capital gains when held long-term because there is less buying and selling of securities inside of them than most mutual funds. As a result, they are considered more tax-efficient than mutual funds, and when including their lower annual expenses every year, are seen as low-cost, low-tax investments. (Low cost AND low tax? Sign me up, right?) An investment portfolio comprised of all ETFs is seen as desirable by investors concerned with both expenses and taxes, but do these reduced investment expenses cause portfolios of ETFs to always outperform portfolios that include other kinds of investments, like mutual funds, on an after-tax basis?

We don't need to conduct an analysis to know that the answer to that depends very much on the quality of the investments chosen and how the portfolios are allocated. For this comparison we looked at a diversified portfolio of investments we currently use in our client portfolios including ETFs, mutual funds and closed-ended funds. We compared that portfolio to a portfolio of just ETFs, making their stock, bond and alternative exposures identical with 40% stock, 40% bond, and 20% alternative investments. We assumed the investor is in the 25% tax bracket, and all taxes are paid by selling shares of the investments inside the portfolios. The after-tax results of owning those two portfolios since 2011, rebalancing twice a year, are:



In this case the portfolio of mutual funds and other investments outperformed the all ETF portfolio net of taxes. We did not create a portfolio of purposefully tax-advantaged investments for the diversified portfolio, so we did not stack the deck with the purpose of outperforming the ETF portfolio. One test over one 5 ½ year period does not prove that every diversified portfolio will outperform every ETF portfolio on an after-tax basis, but it does show a diversified portfolio is not guaranteed to grow less on an after-tax basis than a portfolio of ETFs even though ETFs are seen as both lower cost and more tax-efficient.

So as not to leave too many stones unturned, we did look at the performance of these two portfolios assuming the investor was in the highest tax bracket and the diversified portfolio still outperformed the all ETF portfolio by an attractive margin. In both cases, the outperformance of the Diversified Portfolio came from the investments that took the most management, namely bonds and alternatives.

As desirable as it is to avoid paying as much in taxes on your investments as possible, it's still what you keep that's most important. Yes, we absolutely do have to keep an eye on what we pay because it does influence how much investments can grow over time, but there are other equally and potentially more important factors at work. As painful as paying taxes on investments can feel, extra growth over time can make paying them worthwhile.

KEY TAKEAWAYS:

- Tax-efficiency is less important to growth over time than the amount of risk carried by a particular investment.

- Even with similar levels of risk, a less tax-efficient investment can outperform a more tax-efficient investment net of taxes.

- Net of taxes, a diversified portfolio that includes investment sectors that require higher amounts of management, like bonds and alternatives, can outperform a portfolio whose investments were chosen mainly for tax-efficiency as opposed to for performance.

The ACA & Retirement Plan Distributions

Whether or not the Affordable Care Act (ACA) is a step in the right direction for healthcare in America is a subject that is hotly debated. It's fair to say that there are a handful of positive changes associated with the ACA such as coverage for those who previously couldn't afford it or who had a pre-existing medical condition. In our opinion, this effect is unquestionably positive. However, there are other aspects of the ACA that are less constructive such as rapidly rising premiums from year to year and a shrinking marketplace as insurers opt out of the program.

One additional aspect of the ACA that could catch retirees off guard is when retirement plan distributions lead to an increase in reportable income to the point where the premium subsidy has to be paid back. This can come into play if your retirement income is low enough to qualify for a reduced premium by way of a government subsidy. Qualifying for this subsidy at time of enrollment often times involves some guesswork as to what your income will be going forward. In most cases, the majority of this income will come from fixed sources such as social security and pensions, but there are other less predictable items that count as taxable income too. Interest, dividends, and capital gains distributions from investments as well as unscheduled or emergency withdrawals from IRA accounts can cause income to jump above what was estimated at the time of plan enrollment. Because subsidies are based on this estimated income, any excess income could require a portion of or the whole subsidy to be paid back when you file your tax return.

Be careful to avoid this. If possible, spread large IRA withdrawals out over multiple years in order to minimize the impact they have on any premium subsidy you may be receiving. In a situation where health care premium assistance is needed, having to pay it back later is anything but helpful.

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